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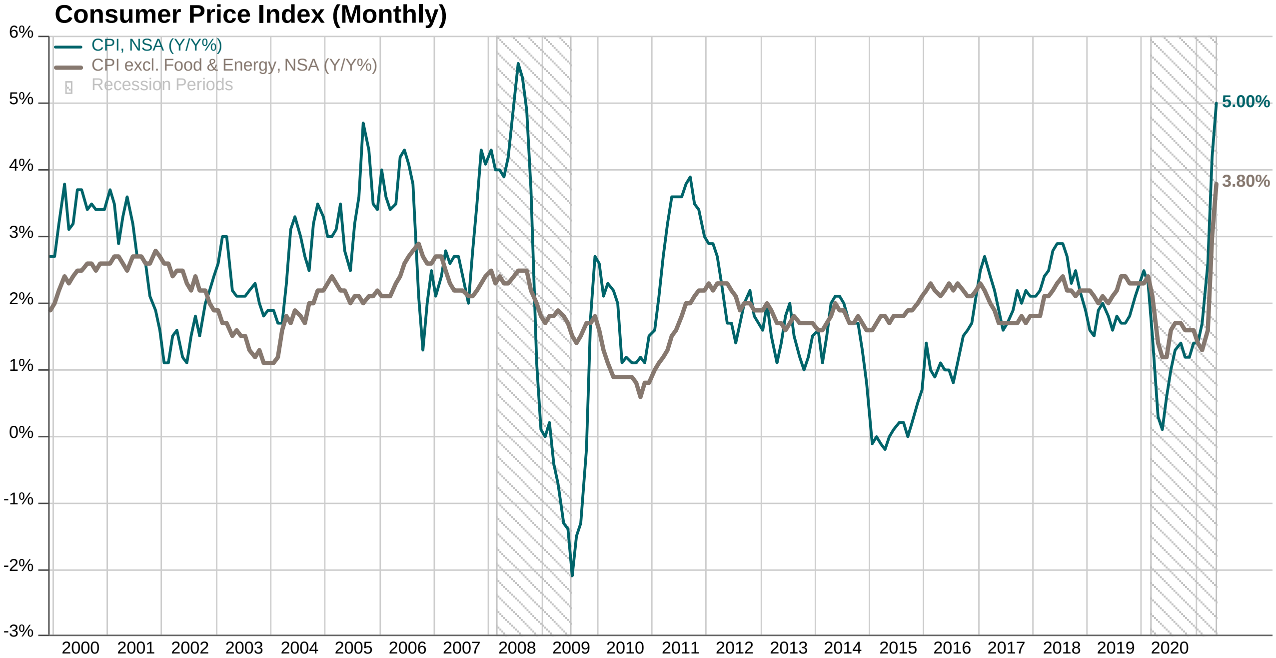
Thinking About Talking About Inflation

Evidence of inflation has emerged across the economy as the CPI (consumer price index, see chart below) and PCE price index (personal consumption inflation) have trended significantly higher in 2021. Given last year's dramatic pandemic-driven economic shutdown, followed by several rounds of equally dramatic government-supplied fiscal stimulus, and businesses reopening this year, it was widely expected that prices for goods and services and commodities would rise as supply chains adjust to surging demand. Of concern to investors is the impact of rising inflation on portfolios, and the uncertain duration of an elevated inflation environment. In recent weeks, despite rising inflation data, U.S. 10-year Treasury bond prices have rallied driving yields lower. This in turn has contributed to a recent equity rally led by the Technology sector that helped drive new all-time highs for the S&P 500 and Nasdaq Composite indices. We believe that inflation fears and uncertainty are likely to remain in place over the remainder of 2021 and into 2022, as global GDP growth recovers, government spending remains elevated, and workers demand higher wages. In addition, the Federal Reserve Bank's (Fed) current policy stance is to "achieve inflation moderately above 2 percent for some time" which suggests it will tolerate elevated inflation for several months without raising the fed funds target or reducing its active securities purchases. **However, we agree with the Fed that much of the inflation pressure in recent months appears transitory; a result of temporary demand vs. supply imbalances that will correct over several quarters. A transitory period of inflation would be consistent with the recent low inflation experience since the financial crisis despite Fed efforts to raise price levels.**

Inflation that is tied to the economic recovery can be positive for some equities as GDP growth drives sales gains and companies can more easily pass along price increases, but inflation pressures will impact companies differently. Broad GDP growth favors cyclical stocks that more directly benefit from the economic recovery, including sectors such as Industrials, Financials, Materials and Energy. At the same time inflation can lead to higher interest rates, but interest rates are driven by multiple factors, with inflation being just one component, and that input could lag as trends are confirmed. The potential for higher interest rates can weigh on already elevated valuations of growth stocks (such as Information Technology and Consumer Discretionary) if higher rates decrease the present value of future cash flows. For most of 2021 (through mid-May) this was the scenario; as cyclical sectors led market gains, while growth stocks underperformed. Longer-term, if inflation continues to rise, while economic growth stalls, we would expect defensive sectors to outperform as those companies are better able to pass through higher prices and demand is less affected by economic conditions. This would include Consumer Staples, Utilities, and Health Care, all sectors that have underperformed the S&P 500 YTD, indicating that investors believe that the above-trend economic growth story fueled by a global reopening will continue. The potential for inflation exceeding expectations and causing the Fed to raise short term interest rates sooner or more than expected, remains a risk for equity valuations in 2021, in our opinion. **We advocate that investors maintain diversified equity portfolios with ongoing exposure to cyclical sectors and we remain comfortable with market-weight exposure to the Technology and Consumer Discretionary sectors, which combined comprise 39% (as of 6/15/21) of the market capitalization of the S&P 500 index.**

Consumer Price Index (Monthly)



Source: FactSet, Bureau of Labor Statistics as of 5/28/21

Consumer prices, as measured by the Consumer Price Index for Urban Consumers (CPI), rose to the highest levels in nearly 13 years in May 2021, not only recovering from the multi-year low prices in 2020 during the pandemic-driven shutdowns, but also rising significantly above pre-pandemic levels. It is helpful to look at inflation data in different ways, including watching month-to-month pricing trends in addition to Y/Y movements, which are reflected above. The CPI chart above shows the monthly Y/Y price change from 2000 to 2021 for both the CPI and the core CPI (which excludes the impact of food and energy). The May CPI increase of 5.0% was the highest since 2008, and followed a 4.2% increase in April. Core CPI of 3.8% was the highest since June 1992, after remaining relatively close to 2.0% over the past several years. Rising inflation was expected in 2021 as consumer and business demand surges, but much of the recent price surge does appear transitory.

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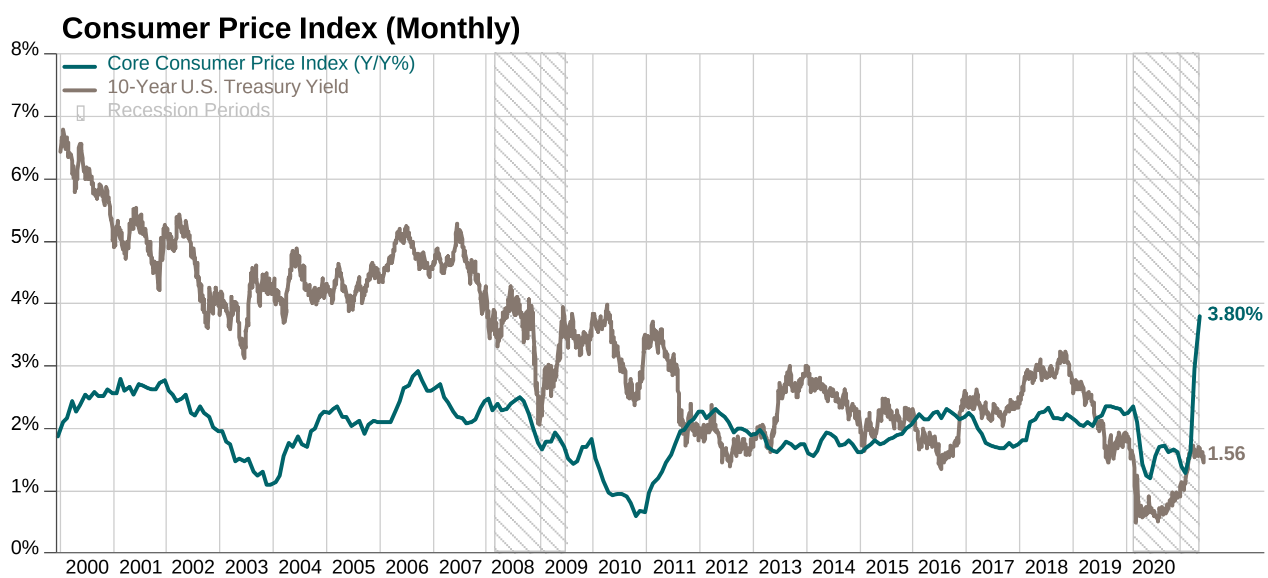
Within May's 3.8% Y/Y increase in core CPI, prices for used cars and trucks rose 30%, motor vehicle insurance pricing increased 17%, and rates on rental cars surged 110%. Prices for new vehicles were 3.3% higher. Those price increases are easily explainable as automotive markets have been disrupted by a transitory shortage of semiconductors, as well as a pandemic-driven shortage of both used cars and rental vehicles. We expect those headwinds to fade with time. In the headline CPI number of 5.0%, food away from home (eating out) prices increased 4.0%, and energy costs (home and automotive) surged 28.5%, including a 56% rise in the gasoline index. Other categories where prices increased from April to May included household furnishings, airline fares and apparel. Many of these categories are expected to level out or decline this year, and a two major CPI categories reflected a more modest annual increase. The housing index, which comprised 41% of CPI in 2020, increased just 2.2% Y/Y in May 2021, and medical care prices rose just 0.9%. We expect inflation to remain elevated throughout 2021, but April and May could represent the peak levels in this cycle. In recent weeks we have seen lower commodities prices for lumber, copper, corn, and soybeans, among others. The Fed concluded its June 2021 FOMC meeting on 6/16/21 and its Summary of Economic Projections (also called the "dot-plot") showed 2021 estimated PCE inflation of 3.4%, but policymakers see inflation pulling back to 2.1% in 2022. While the 2021 estimate of 3.4% was higher than the Fed's average estimate of 2.4% in March 2021, the 2022 estimate of 2.1% was consistent with the 2.0% projection in March, suggesting the Fed believes the current state of elevated inflation is transitory.

Over the past couple of months, long-term U.S. interest rates have declined modestly, while inflation has surged. The U.S. 10-year Treasury yield ended May at 1.58%, which was down from 1.73% on 3/31/21. This is surprising given the inflation increase over two months, but not as surprising if the Fed is right and much of the recent inflation surge is transitory. The 10-year U.S. Treasury yield began 2021 at 0.92%, and increased materially in Q1. To some extent this reflected expectations for renewed GDP growth and inflation, and for a brief period in Q1 the 10-year yield exceeded the core inflation rate. But inflation is again above long-term interest rates, a condition that has largely existed since late 2019. If the 10-year yield remains below core inflation, which effectively makes real yields negative, we would broadly expect growth stocks to relatively outperform. Not only because low rates support a higher present value of future cash flows, but also because the low rates suggest that bond investors see a lower GDP growth environment in future periods. Since May, the S&P 500 Technology sector has outperformed most other sectors, an indication that equity investors have moved some assets back to growth stocks.

In a normal healthy economy, we expect U.S. 10-year Treasury yields to exceed core inflation, and we continue to have a positive view for a strong post-pandemic U.S. economy. As of 6/15/21, the FactSet consensus U.S. GDP growth estimates for 2021 and 2022 were 6.5% and 4.0%, respectively. To bring real interest rates (10-year Treasury yield less core inflation) back to a normal positive level, either inflation moves lower or Treasury yields move higher. We expect a combination of both, initially from a decrease in transitory core inflation, and then from a gradual increase in long-term interest rates. This view is supported by the Fed's average estimate of core PCE inflation of 2.1% in 2022, and the view that transitory inflation might have peaked in April and May. We also believe that 10-year Treasury yields will move higher over time, although it could be well in to 2022 before we see a 10-year Treasury yield above 2.0%. We believe this would be a positive environment for dividend stocks, as companies benefit from the economic recovery, elevated but transitory inflation, and investors' hunt for yield. These factors have led to strong Q2 gains for the S&P Real Estate sector and we believe that the REIT sector appears well-positioned over the balance of the year.



Source: FactSet, Bureau of Labor Statistics; Core Consumer Price Index data as of 5/28/21, U.S. 10-Year Treasury Yield data as of 6/16/21

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Inflation and U.S. Treasury Yields: The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers. The all urban consumer group represents about 93 percent of the total U.S. population. It is based on the expenditures of almost all residents of urban or metropolitan areas, including professionals, the self-employed, the poor, the unemployed, and retired people, as well as urban wage earners and clerical workers. The CPI is reported monthly by the Department of Labor. The PCE price index, also called the PCE deflator, is a similar, alternative measure of inflation tracking the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. It is reported monthly and quarterly by the Bureau of Economic Analysis. The yield of the 10-year U.S. Treasury bond is a widely followed barometer of the current environment for U.S. long-term interest rates.